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Made in Japan

“But what about the fallacy of composition? How would the nation fare as a whole if companies . . . saw the maximization of shareholder value as their only responsibility? If they ignored customers, employees, the ‘national interest’ in order to focus on making their stock more attractive to the computers that pick them? The answer is obvious: If companies were run just for the shareholder, it would be as disastrous to the country as if everyone saved during a depression. Perhaps more.”

The Death of Money
Joel Kurtzman, 1993

False signs of an economic rebound have shaken Wall Street from its complacent dreams of easy money and endlessly rising stock and bond prices. Stunned by the supposed strength of U.S. job growth in February, the markets reacted violently, switching abruptly from hopes for further Fed easings to fears of Fed tightenings to come.

As always, Wall Street's manic mood swings bear little relationship to reality. The February jobs report provided a grossly distorted view of the health of the U.S. expansion. At best, the economy is experiencing a mild rebound from bad winter weather and the federal government shutdown. At worst, the slide toward recession already has resumed.

In any case, investors and speculators have focused their attention on the wrong central bank. Given its predilection for loose money, we have little doubt the Greenspan Fed will seize the first opportunity to lower rates. Doing so last month, in the wake of the February payroll surge, would have been too brazen even for Mr. Greenspan. By the time the Open Market Committee meets in May, we think it will have more than adequate justification for easing.

Instead of watching the Fed, investors should keep their eyes trained on the Bank of Japan. Through its massive dollar interventions and record-low interest rates, the BoJ has become the driving force in global bond markets. Directly or indirectly, the BoJ now is financing the lion's share of the U.S. budget and current-account deficits.

February's bond sell off, which actually predated the disastrous U.S. payroll report, clearly demonstrated the BoJ's influence. The merest hint by a Japanese politician that the BoJ might raise rates sent global bond markets reeling, as the leveraged yield-curve players rushed to unwind positions financed with cheap, borrowed yen. That rout easily could have turned into a general crash had not the BoJ moved aggressively to shore up the hard-pressed dollar.

We see little risk the Bank of Japan will abandon its role as guardian of the dollar. The bureaucrats in Japan's Ministry of Finance clearly are unwilling to tolerate a stronger yen, which would crush their desperate efforts to reflate the Japanese banking system. However, the growing reluctance of private investors to hold dollar assets ensures the BoJ will be forced to continuously expand its own purchases of the U.S. currency in order to curb the yen's rise.

The BoJ may prevent a full-blown dollar crisis, but a more fundamental threat hangs over Wall Street. Growth is faltering in the major industrial countries, despite the general trend toward easy money. The powerful investment cycles that once fueled economic expansion – and inflation – are dying, neutralizing the effects of loose monetary policy.

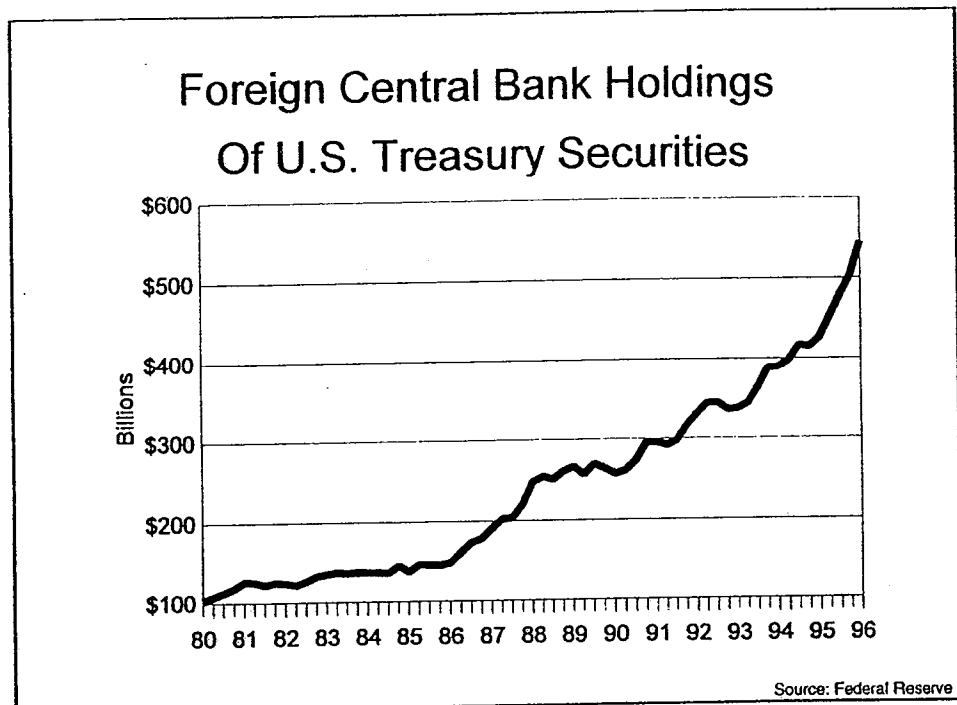
While the impact on U.S. business profits has been mitigated by widespread corporate downsizing and the consumer borrowing binge, the ill effects of stagnating fixed investment cannot be offset forever. A profits crisis is brewing, one that we think will fall heavily on the absurdly overvalued U.S. stock markets. This, not some illusory fear of accelerating growth, is the real danger facing Wall Street and financial markets worldwide.

PHONY CURRENCY STABILITY

Considering the global plunge of bond prices and the up and down yo-yo movements in world stock markets, currencies have shown surprising stability in recent weeks. But what kind of stability is it? We would say it is a false calm, one that has lured currency traders into an equally false sense of security. Who do we have to thank for this mysterious tranquility after the gyrations of February? The world's central banks, and the Bank of Japan in particular.

In a single week in early March, Federal Reserve custody holdings of U.S. Treasury securities for foreign central banks skyrocketed by no less than \$17.7 billion. In the first three months of 1996, these holdings have risen more than \$50 billion. Over the past 12 months, they've jumped \$130 billion, bringing the total to a staggering \$545 billion – \$165 billion more than the Fed's own Treasury holdings. Japan alone accounts for over \$200 billion, or nearly 40% of that massive sum. Taiwan is the second largest official dollar holder, with an estimated \$90 billion in reserves, followed by mainland China, with about \$76 billion.

The plain fact is that foreign central banks are adding to their dollar reserves at an ever-increasing speed. Why? Some time ago, a leading U.S. Treasury official hailed these purchases as a reflection of international confidence in the U.S. currency. It's hard to imagine a more ludicrous explanation. Most obviously, the sole compelling motive for foreign central banks to expand their dollar reserves is their ardent desire to prevent or slow down the appreciation of their own currencies against the dollar, thus curbing the damage to the international competitiveness of their export industries.



The grim message behind these central bank interventions is simply this: Private capital inflows into the United States are no longer sufficient to cover the dollar outflows through the U.S. current and capital accounts. Year by year, this shortfall is worsening.

The identity of the largest dollar buyer is an open secret. It is the Bank of Japan. Faced with the sudden unwinding of the "yen carry trade" bubble, which allowed international speculators to borrow yen at 0.5% to invest in high-yielding U.S. and European bonds, the BoJ chose to bail those speculators out by purchasing a completely unprecedented amount of dollars – in excess of \$20 billion in February alone. As usual, these dollars were channeled into the BoJ's custody account at the Fed, and hence into the Treasury market. Weighing the stunning amounts involved, one has to wonder how low both the dollar and U.S. bonds would have fallen in the absence of the BoJ's massive interventions.

Plainly, market forces no longer are allowed to operate freely, at least, not in the case of the dollar. Is there any limit to the BoJ's ability to rig the dollar rate? The answer, at least for the foreseeable future, is no. The BoJ can buy as many dollars as it wants, as long as it wants. But the trend is decidedly ominous. With each crisis, the BoJ must vastly increase the scale of its interventions to prevent the dollar from collapsing against the yen.

Why is there no theoretical limit on the BoJ's operations? When central banks intervene, it generally is to prevent a depreciation of their own currency by selling some of their foreign currency reserves. By definition, those interventions

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (March 29)	Month	YTD	Y-Y	Vs. 12- Mo. Hi	Vs. 12- Mo. Lo
Australia	2.1%	1.0%	17.6%	-0.3%	18.1%
Canada	-0.5%	5.5%	15.6%	-1.8%	17.0%
France	2.7%	9.2%	10.4%	0.0%	18.8%
Germany	0.5%	10.3%	29.5%	-1.6%	29.6%
Hong Kong	-1.5%	8.8%	25.5%	-5.5%	33.4%
Japan	6.4%	7.7%	30.0%	0.0%	47.8%
Mexico	8.5%	10.6%	69.7%	-1.0%	71.5%
Spain	-1.5%	6.2%	33.8%	-1.6%	33.8%
U.K.	-0.7%	0.3%	17.7%	-2.2%	17.9%
U.S.	0.8%	4.8%	28.3%	-2.4%	28.9%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (March 29)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12- Mo. Hi	Vs. 12- Mo. Lo
Australia	8.90	28	63	-129	-129	93
Canada	7.63	10	55	-94	-98	69
France	6.61	-5	-2	-136	-136	34
Germany	6.44	5	41	-73	-75	64
Japan	3.24	-26	17	-51	-53	64
Spain	9.72	6	2	-280	-280	46
U.K.	8.18	18	76	-35	-35	94
U.S.	6.32	22	75	-81	-88	80

Exchange Rates

Versus U.S. Dollar, % Change

Country (March 29)	Current Rate	Month	YTD	Y-Y	Vs. 12- Mo. Hi	Vs. 12- Mo. Lo
Australia (\$)	1.28	2.5%	5.1%	7.7%	0.0%	9.5%
Canada (\$)	1.36	0.7%	0.1%	3.1%	-2.3%	3.1%
France (f)	5.03	0.5%	-3.0%	-3.6%	-5.8%	2.0%
Germany (DM)	1.48	-0.2%	-2.7%	-6.7%	-9.1%	1.1%
Japan (¥)	107.3	-1.9%	-3.7%	-21.4%	-33.0%	0.1%
Spain (P)	124.1	-0.5%	-2.2%	2.9%	-5.0%	3.1%
U.K. (£)	1.53	-0.3%	-1.7%	-5.3%	-6.0%	1.5%

are limited by the availability of foreign reserves, or by the ability of the intervening bank to borrow from the central bank possessing the strong currency. In this instance, however, the roles are exactly reversed. The BoJ is intervening to prevent a dollar collapse, not a yen devaluation. The BoJ's dollar purchases can go on indefinitely because it pays for those dollars with yen, which it can create ad infinitum.

The big question, then, is not whether the BoJ can go on piling up dollar reserves, but rather what might lead it to stop. Given the Japanese government's absolute determination to prevent a yen revaluation, we can see no immediate motive for the BoJ to change course. Indeed, the collapse of the yen carry trade probably will force the BoJ into even larger dollar purchases in coming months.

As we explained in our last letter, the yen-based yield-curve play amounted to a monumental bet on persistent economic sluggishness and monetary ease on both ends of the trade. In the United States and Europe, it was essential that economic weakness continue to drive bond yields down, or at least hold them steady. In Japan, continued stagnation was essential for the maintenance of extremely low yen interest rates.

AT THE BANK OF JAPAN'S MERCY

Actually, those bets were well founded. But two things tripped up the speculators. First, in a fit of political anxiety, Japan's Finance Minister, Wataru Kubo, suggested a BoJ rate increase might be welcomed by Japan's pensioners, who have seen the yields on their savings shrivel to virtually nothing as a result of the BoJ's rate-slashing policies. While Kubo was not speaking for the powerful bureaucrats who actually run the Ministry of Finance, this fact apparently wasn't completely understood in the markets. Faced, or so they imagined, with the risk of a BoJ rate hike, carry-trade speculators hurried to unwind their highly leveraged positions.

The second blow fell on the other side of the Pacific, where a string of economic reports, ending with an astonishingly strong February jobs report, fueled a spreading perception in the markets that U.S. economic growth might be stronger than expected, thwarting the Fed's obvious desire to cut rates. The resulting slump in bond prices added to the distress of the speculative carry traders, fueling even more selling.

It would be easy to blame these trivial setbacks for the carnage in the bond market. Yet the true villain, of course, is the entity that created the bubble – the Bank of Japan, in this case – not the trigger that punctured it.

We have said it again and again: Every speculative bubble foreshadows its later bursting. That's the key point to see. It's also the reason why these letters have devoted so much attention to the question of whether the current global

bull market is a speculative bubble or not. Our evaluation is based on a straight-forward analysis of the sources of the money flowing into the assets markets. The true test of any bubble is that the money fueling it comes not from current savings, but rather largely or even overwhelmingly from money and credit creation, or from a mass movement out of cash. All of this is very easy to check.

For the European economists of the 1930s, this distinction between savings and inflationary money flows was elementary. In their view, interest rates were determined by the interplay of the demand for capital with the supply of new savings available to meet that demand. Inflationary, speculative supplements to real savings were an evil to be avoided, because they would create unsustainable distortions in the economies and in the markets.

This equilibrium concept of classical economics was swept away by John Maynard Keynes. He denied savings had any major role to play in the determination of interest rates. Faced in the 1930s with the Great Depression, he wanted the lowest possible interest rates, to restart the engine of fixed investment. According to his theory, the chief factor limiting a decline in rates was the public's liquidity preference, as it related to the existing monetary stock. All that was needed to lower interest rates, Keynes postulated, was a monetary policy that drove money holders out of their bank balances and into securities.

This, of course, was precisely the ploy used by the Federal Reserve in 1991-93. By driving the federal funds rate to 3%, the Fed set off a furious race out of money and into bonds and stocks. This stoked a speculative bubble that cracked as soon as the Fed began to nudge rates higher in 1994. Apparently undeterred by this dismal American experience, the Bank of Japan has used the same technique to try to jump start the Japanese economy, slashing its key money-market rate to a historic low of 0.45%.

But while this rock-bottom rate so far has had relatively little effect on Japan's economy, it has been most successful in fostering yet another big global bond bubble, this time financed with ultra-cheap yen instead of cheap dollars. In 1994, when the Fed's bubble burst, the U.S. central bank was unable to prevent a near disastrous plunge in bond prices and the dollar. This time, the Bank of Japan came to the rescue of both the dollar and the U.S. bond market. Realistically speaking, both the dollar and U.S. bonds now are completely at the mercy of the Bank of Japan.

Considering how far bond prices nevertheless plunged, it is frightening to think about what would have happened without the BoJ's massive interventions. It well might have set off the great crash we have feared for so long, by driving U.S. long-term bond yields to 8% or higher. One can only imagine the havoc this would have raised in the stock markets.

What frightens us most is the complacency and blindness – even on the part of policy makers who should know better – to the financial instability inherent in this repeated pattern of speculative excess and subsequent collapse.

THE DOLLAR: WEAK OR STRONG?

Once again, the U.S. dollar confounds the experts. Early this year, it was the market's familiar consensus that the dollar would stage a strong rebound in the course of 1996. Well, with massive support from the BoJ, the dollar did manage to stage a resurgence against the yen. But its upward move against the DM has proven much less robust than expected – despite acute signs of economic weakness in Germany.

The latest burst of dollar optimism was rooted in the diverging performance of the real economies. Doom and gloom about Japanese and German economies contrasted with near euphoria about the new-found health and strength of the United States. Indeed, recent data seem to show the U.S. economy re-accelerating, giving fresh heart to the dollar bulls.

The bulls would appear to have ample empirical evidence on their side. In the past, whenever the U.S. economy has expanded relative to the rest of the world, the dollar has predictably strengthened, more often than not very sharply. This pattern has held for several decades now. The most dramatic and noteworthy case, of course, was the Reagan recovery that started in 1982. In the face of an exploding U.S. trade deficit, the dollar shot skyward. Soaring capital inflows more than offset the rising dollar outflows created by the trade shortfall.

Looking at the U.S. economy and the dollar, what is the difference between then and now? Are there not some important similarities, such as the superior performance of the U.S. economy compared with Europe and Japan? Yes, but U.S. monetary conditions in the early 1980s and presently are as different as night and day.

A DISASTROUS TREND

During 1983-85, the cumulative U.S. current-account deficit totaled \$270 billion, rising to \$400 billion in the following three years. That's quite a dramatic deterioration. But in order to fully understand the dollar's worsening fundamentals, it is necessary to take a look at the equally dramatic change in the financing of that current-account deficit.

In 1983-85, identified dollar reserves rose by a minimal amount – just \$11 billion. Virtually the entire current-account deficit was financed by a surging inflow of private capital. The dollar's sharp rise in that period actually indicated that those flows exceeded – that is, over-financed – the U.S. deficit.

Apparently beguiled by this brief interlude of autonomous dollar strength, the bulls have been waiting for an encore ever since. Assiduously, they close their eyes to the fact that private capital inflows have become increasingly scarce. To prevent a dollar collapse, foreign central banks have been forced to step in repeatedly, reviving the trend of the late 1960s and 1970s. Indeed, the Reagan interlude proved all too painfully brief. By 1986 and 1987, when the U.S. deficit totaled \$300 billion, official dollar purchases covered half of that shortfall.

That trend has only worsened in the 1990s. Over the three years 1993-95, the cumulative U.S. current account deficit reached \$400 billion. Foreign central banks, meanwhile, increased their dollar reserves by some \$260 billion, or 65% of the U.S. deficit. At the same time, massive private capital inflows gave way to massive capital outflows. To speak of a strong dollar under these conditions is really quite ludicrous.

It goes without saying that the dollar's secular decline finds its primary reason in the huge current-account deficit. Therefore, our first task should be to understand the primary reason for this deficit. Obviously, such a large shortfall implies an excess of spending over domestic production and income growth. Credit inflation is required to sustain that overspending. In the last analysis, the source of any current-account deficit can be found in a credit expansion in excess of domestic savings. For the old economists, such a deficit was proof positive of monetary inflation.

THE U.S. EXTERNAL DEFICIT: TOO BIG TO SWALLOW

If we take the U.S. current account as a given, future dollar strength depends entirely on a very strong capital account. That is, the U.S. economy must continue to attract foreign capital on a massive scale, as happened in 1983-85. Is this possible? We have given the matter the most careful scrutiny. To preview our analysis with a short answer: It is impossible. A U.S. current-account deficit of \$100 billion or higher is far too big a financial chunk to be swallowed by private global investors. Alas for the dollar bulls, the 1983-85 experience was exceptional. There is absolutely no chance now for a dollar rally based on the U.S. capital account over-financing the current account.

To understand why, it is important to remember the global environment at the beginning of the 1980s. The decade opened with a second oil shock, high inflation rates and double-digit interest rates resulting from the Reagan tax cuts and the Volcker Fed's drastic monetary squeeze. Even when the Fed finally eased in the autumn of 1982, initiating a powerful economic recovery, U.S. interest rates remained high by international comparison.

Actually, owing to the Fed's extremely tight grip on reserves, banking flows, not portfolio flows, played an overriding role in turning around the U.S. capital account. Strictly speaking, the strong dollar had more to do with the Volcker monetary squeeze than with any great foreign demand for U.S. bonds and stocks.

Today, by contrast, low inflation and moderate economic growth are keeping U.S. monetary policy rather easy, while U.S. bonds and stocks offer little value by international comparison. Not only that, but there now are a host of investment opportunities that didn't exist a decade ago, in Asia, Latin America and Eastern Europe.

As a matter of fact, American investors are leading the global investment boom, creating capital outflows so large they now outpace the U.S. current-account deficit. And big fiscal deficits no longer are the sole privilege of the United States – Japan and the European nations have relatively bigger ones.

Finally, we offer two more numbers as food for thought. At year-end 1982, foreigners held roughly \$740 billion in dollar assets. Today, they hold well over \$3.5 trillion. That rise has far outstripped the natural increase in dollar portfolios that could be expected from economic growth and increased trade. The world is drowning in dollars.

The most recent outbreak of dollar bullishness was largely based on the view that the German mark is being undermined by the unfolding recession in Germany and the prospects for European Monetary Union. Up to a point, that view certainly is true. But it also is true that the U.S. economy is far too sluggish to attract the capital inflows needed to compensate for the current-account deficit and massive capital outflows. If the DM has one strike against it, the dollar has many more.

THREE-CAMP CONTROVERSY

The debate over the likely course of the global financial markets in coming months splits analysts and pundits into three camps. One group expects a continued soft landing for the U.S. and global economies. Another fears an acceleration in growth and inflation. Still another group foresees near-recession conditions.

The first camp, now probably in the majority, regards the current economic slowdown in the U.S. and Europe as a brief pause that will evolve into a synchronized global upturn later this year. In this view, the recent sharp spike in bond yields is a premature warning of the coming recovery.

Nevertheless, this group expects economic growth to remain subdued, guaranteeing continuous low inflation and an absence of any monetary tightening. In short, they see more of the best of both worlds, as rising profits generated by cost cutting and accelerated productivity growth continue to support equity valuations, despite modestly higher rates.

The second camp, on the other hand, is haunted by inflation fears. This group tends to stress the past and present reflationary efforts of the central banks, and warns that, as usual, they will go to excess, leading over time to higher commodity and consumer prices, badly impacting the financial markets.

The third camp, to which we must confess we ourselves have an affinity, is attuned to extended economic weakness and possible recession, both in Europe and North America.

Until recently, this last point of view apparently was widely held in the markets, judging by the rampant bull speculation in bonds. But the recent, stronger-than-expected data have caused many speculators to desert to the first camp, where they now look forward to recovery of the U.S. economy later in the year.

On the surface, we disagree most strongly with the residents of the second camp, whom we shall dub the inflation hawks. Yet we hasten to add that we just as strongly disagree with the widespread, rosy view that inflation has been wrung out of the world economy once and for all by ever-vigilant central banks and financial markets, who have learned to strike against it with preemptive action.

As a matter of fact, we see rampant inflation. But its main outlet is not in the prices of goods and services, but rather in the financial markets, and (in countries such as the United States) in huge trade deficits. If not for the big demand-absorbing trade deficit, U.S. consumer- and producer-price inflation undoubtedly would be much higher than they are today.

In the United States, inflation traditionally has been defined as a sustained rise in the prices of goods and services. By contrast, traditional European concepts of inflation have a common thread, in that they all attempt to define inflation in terms of its chief cause, which is excess credit and money creation. Or, to put it differently: Americans focus on a

single symptom, while Europeans look at the underlying disease. That's why most Americans, in contrast to European, simply have failed to grasp the concept of asset inflation.

Persistently low and falling inflation rates, as measured by the conventional price indexes, have been the great, pleasant surprise for the industrialized countries in the 1990s. Will they last? We think, with minor fluctuations, that they will. But what broke the back of the old wage-price spiral? Was it really the work of more clever central bankers and investors – as is conveniently argued now by those selfsame bankers and investors? If not, what else can explain the death of inflation?

THE DEATH OF THE INVESTMENT CYCLE

In our view, low and falling inflation rates have one predominant reason, and it is far from positive. We believe we are witnessing the death of the strong investment cycles that used to drive the larger business cycles, and that have fueled long-term economic growth since the dawn of industrial capitalism. The unpleasant but inevitable consequences of these investment booms were higher rates of consumer and commodity inflation.

But today, throughout the developing countries, fixed investment and economic growth have become so anemic that easy money has lost much of its power to generate inflation, except for asset-price inflation, which is all the more virulent. In 1991-93, the Fed applied its most aggressive monetary easing ever, yet the economy responded with unusual sluggishness. The resulting real GDP growth was barely half as strong as in the average postwar business cycle.

If businesses want to expand, they now do so overwhelmingly by means of mergers, acquisitions and direct investment in low-wage countries. Essentially, this is largely as the expense of investment in domestic plant and equipment. In the last analysis, we have managed to cap inflation by capping economic growth.

Actually, there is a perception in some quarters that the industrialized countries are in the grips of a mild deflation, leading to the chronic weakness of demand and forcing corporations into aggressive downsizing. This is sheer nonsense. The obvious and conclusive counter evidence is in the booming financial markets. In a truly deflationary environment, asset markets would be the first to collapse – as they have in Japan.

A more accurate description is to say that the industrialized countries have replaced the former booms in tangible assets with a boom in paper assets that are no longer backed by physical capital. Hence low growth and low inflation.

The truth is that the decline in investment and the policy of downsizing are precisely the most important causes of the general slowdown in GDP and income growth. By curtailing investment spending, businesses intrinsically curtail overall production and employment, with contractive effects on consumer incomes. This sets up a perfectly vicious circle of economic contraction. In every economy, the business sector is the one true engine of growth. When it retrenches, it puts the entire economy under downward pressure.

DOWNSIZING BECOMES A GROWTH TRAP

Downsizing may be a brilliant device to push profits up in the short run, but it's a trap that undercuts economic growth and profits in the long run. Indeed, the U.S. economy would long since have found itself in big trouble if the consumer had not resorted to frenzied borrowing to maintain his living standards – to the benefit of business profits.

Europe, with its high wages, used to have strong investment cycles. But in the cycle just ended, it came to almost nothing in most countries. In many EC countries, fixed investment even declined year-over-year, aborting the lackluster recovery. Unemployment has soared, as firms have slashed their payrolls. But unlike in the United States, no consumer borrowing binge has come to the rescue.

Superficially, the recent U.S. experience seems to contradict our conjecture of dying investment cycles. In contrast to the pitiful investment trend in Europe, the U.S. economy has experienced an exceptionally strong upsurge in business investment. Oddly, this has failed to spur a more powerful business cycle.

We suspect that this shortcoming of the U.S. investment boom stems from its skewed pattern. Indeed, statistics show clearly how narrowly based it was. Computers and other information-processing equipment have accounted for almost 70% of U.S. fixed business investment since 1990. Other producers' equipment and structures provided just 32%. And those figures are derived from the chain-weighted GDP accounts, which correct much of the previous bias toward computer investment. By and large, computer production involves little input of material and labor. Consequently, it lacks the powerful multiplier effects that previous investment booms have had on the rest of the economy.

EUROPE'S EMPLOYMENT AND GROWTH CRISIS

In Europe, opinions about the economic prospects are no less controversial than in the United States. A bounce back is almost inevitable after this year's hard winter. But, given both the EMU-related general obligation to reduced outsized budget deficits, and the downtrend in fixed investment, the only potential motor for expansion is foreign trade.

For good reasons, therefore, the main hope for avoiding a protracted recession is the synchronized global recovery that the international consensus is forecasting for later this year. Even so, it is a very contained optimism.

Europe's jobs crisis has been long in coming. But the politicians and the public took little notice of the approaching storm. In fact, the great majority of the employed helped themselves to substantial real wage rises. But news that even in Germany the unemployment rate has passed 11% apparently has shocked many people out of their former lethargy.

In the community as a whole, the unemployment rate so far in the 1990s has jumped from 8.7% to almost 12%. More than 20 million workers have been idled. Even in the face of the economic recovery, employment has declined by a cumulative 4% since 1992, resulting in nearly six million net job losses. Most shocking has been the realization that in Europe, too, traditional job security is crumbling. For the first time, large firms are undertaking job cuts while at the same time announcing record profits.

Tax Receipts and Government Spending As a Percentage of GDP				
Country	Tax Receipts		Government Spending	
	1990	1995	1990	1995
Belgium	48.8%	50.0%	54.2%	54.2%
France	49.0%	49.3%	50.5%	54.1%
Germany	43.3%	47.0%	45.3%	49.1%
Spain	39.5%	40.7%	43.4%	46.7%
Italy	42.2%	45.6%	53.2%	53.5%
Netherlands	49.9%	49.6%	55.0%	52.9%
United Kingdom	38.8%	37.7%	40.3%	42.5%
Sweden	64.9%	60.1%	60.7%	69.2%

Source: The European Commission

In Germany, 1.1 million jobs have vanished since March 1992, the last employment peak. But vigorous job shedding has enabled businesses to boost their productivity and profits by a stunning 10% since 1991. In the United States, by contrast, productivity has risen just 5.4% since 1991.

There should be no doubts about the reason for Europe's jobs crisis: wages excesses underpinned by welfare-state excesses have fueled excessive government spending and taxation. The table above illustrates the resulting fiscal disaster – and these figures were compiled before the recent dramatic worsening of government deficits throughout Europe.

MR. KOHL MUDDLES THROUGH

Time and again, Chancellor Kohl has urged the Germans to mend their ways and accept sacrifices to ensure a prosperous future. His words always have the right ring, but the follow-up actions are always woeful, if not missing completely. He no longer leads, but rather muddles through. Even his bid to loosen Germany's archaic shopping hours is snagged. Given this complete lack of concrete economic achievements, Mr Kohl's conservative rhetoric and grand

European visions strike most Germans as hollow. His election victories owe much to the fatalistic conviction on the part of many German voters that he is the lesser evil.

It is our foregone conclusion that politicians and trade union leaders throughout most of Europe simply are not prepared to take the drastic policy measures that are required to reverse the current dismal unemployment trends. At best, we can only hope there will be somewhat more wage restraint.

Under these conditions, it is inconceivable to us that the politicians will be able to cut their excessive budget deficits in time to meet the Maastricht criteria. Ironically, even Germany now is missing the mark. The weakening economy catapulted its 1995 fiscal deficit to 3.5% of GDP. On the basis of present planning, it will hit 4% in 1996, well above the Maastricht threshold of 3%. France is even further off course. On present policies, tiny Luxembourg will be the only country to qualify for monetary union in 1999, assuming the convergence criteria are strictly interpreted.

There can be no doubt that leading politicians in both Germany and France would prefer to push EMU through, even if it requires fudging the convergence criteria. In doing so, they would undermine the credibility of the new currency right from the start. But Germany's leaders, as well as the Bundesbank, have committed themselves to a strict interpretation of the criteria. We think they would find it difficult now to accept a serious bending of the rules.

In any case, the German federal elections in late 1998, just a few months before the scheduled start of EMU in 1999, no doubt will be a crucial factor in the final decision. It should be remembered that EMU is opposed by two-thirds of the German population.

Mr. Kohl continually declares to all who will listen that failure of EMU would be "catastrophic." We can only ask: catastrophic for whom? For the people of Europe, or for Kohl and the rest of Europe's self-serving political establishment?

THE DM VERSUS THE DOLLAR

Returning to present-day currency questions, we note that most forecasters are moderately bullish on the dollar against both the yen and DM, at least in the near term. Their key considerations are the expectation that lower economic growth will be combined with considerably lower short-term interest rates in Japan and Germany, plus the assumption that the threat of EMU will deter foreign buying of DM bonds.

We would reply that a German discount rate presently at 3% and a Bundesbank repo rate of 3.3% leave precious little room for any further cuts. The discount rate has only once before been below this level, and that was briefly after the stock market crash of late 1987. In retrospect, Bundesbank officials probably share the common view that the 1987 episode was excessive and unnecessary.

Pressure on the Bundesbank to lower interest rates comes mainly from abroad, above all from the speculative community, for whom any minuscule rate cut is important, given their penchant for taking outsized leveraged positions. In Germany itself, few people harbor the belief that such a cut would do much good for the real economy. It is widely realized that the present economic weakness is due mainly to structural, not cyclical causes. German businessmen are not waiting for the Bundesbank to cut rates, but rather for Mr. Kohl and his government to begin the unpleasant job of reigning in the fiscal deficit.

On the other hand, we think the picture of rebounding U.S. growth painted by recent economic reports is almost entirely an illusion. Gyration caused by weather, strikes and government shutdowns are playing havoc with the seasonal adjustments.

A particularly bizarre case in point was the February unemployment report, which so roiled global bond markets. The trigger for that turmoil was the announcement of a steep, 705,000 rise in U.S. nonfarm payrolls, following a January decline of 188,000. This sounds impressive, but consider that before seasonal adjustment, nonfarm payrolls actually plunged by nearly 1.75 million in the two months.

This delusion of a strengthening U.S. economy may persist for a bit longer, thanks to the heavily distorted statistics that have appeared in recent weeks. But, as the economy's true state of weakness gradually emerges, we expect over time to see more rate cuts by the Fed than by the Bundesbank. But in any case, we think that the current, modest differences in economic growth and interest rates between the two countries are of very little or no importance to the currency markets.

THE U.S. AND GERMAN CAPITAL ACCOUNTS: A STUNNING COMPARISON

Earlier, we stressed the crucial role of the horrendous U.S. trade and current-account deficits in keeping the dollar under ceaseless downward pressure. By this measure, the DM is in much better shape. Germany's chronic trade surplus rose last year to DM 93.4 billion, from DM 73.3 billion in 1994. The German current-account deficit fell to DM 24.8 billion from DM 34.7 billion in 1994. Considering the tremendous demand pressure from reunification, this excellent performance hardly gives reason for DM pessimism.

A large gap in a country's external account essentially requires correspondingly higher net capital inflows in order to maintain currency stability. But in the U.S. case, the trouble is that the huge current-account deficit is compounded by the U.S. investment community's frenetic speculation and investment in foreign securities. Net capital outflows surged last year to \$280.1 billion, more than double the outflows of 1994.

To cover both its gaping current-account deficit and its foreign investments, the United States must attract roughly \$400 billion in foreign capital and hot money each year. That sum simply defies the potential supply of funds by private investors and lenders in the rest of the world. As we noted earlier, the missing billions are being supplied by foreign central banks.

To compare the German and U.S. capital accounts is a stupefying exercise. The German side reflects extreme financial conservatism. Shying away from risk, the German investor stays home. The biggest source of 1995 German portfolio outflows was the purchase of DM 24.3 billion in foreign bonds, 30% of them DM-denominated. In foreign stocks, there actually was modest net selling. This compares to some DM 82.8 billion in net purchases of German bonds by foreign investors.

THE TRUE BEAR IN BUNDS

Recently, international analysts have critically elaborated on the fact that German government bonds yields have been hovering above comparable U.S. Treasury yields – despite a German inflation rate of only 1.4%. They conclude this must be due to the deterrent effect of EMU. In other words, international investors are writing off the DM.

While this may seem like a reasonable explanation, it is grossly contradicted by the facts. The early bears in the German bond market were domestic investors, not foreigners. While domestic investors were modest net sellers of Bunds, foreigners stepped up their purchases, reaching a record high DM 28.4 billion in January – just in time for the February crash.

This foreign speculation, no doubt, was greatly emboldened by the sudden weakening of the German economy, which was seen as a harbinger of further Bundesbank easing. So what drove the German investor out of the market at the same time? In short, it was simple yield considerations.

German investors have a long tradition of ceasing their purchases of domestic bonds whenever their yields fall below 6%, which is precisely what happened last November. Under such circumstances, German investors prefer to add to their liquid money balances, as can be seen by the sharp acceleration in the broad money supply in early 1996.

In any case, comparing German and U.S. bond yields is a flawed exercise. The U.S. bond market has been almost completely rigged, both by the foreign central banks and by the leveraged speculators who follow in their wake.

WIRED WORLD

Looking at the bond markets, one is struck by the violence of the recent gyrations – and by the trivial nature of the disturbances that created them. As the table shows, the steepness of the decline varied from market to market. But the relatively uniform timing of the highs and lows shows how synchronized the various national bond markets have become, and how independent they are of strictly local influences.

Of course, sudden shakeouts in the bond markets have happened before. But past disruptions always came in response to unexpected, drastic monetary tightenings. Yet the latest plunge occurred against a background of monetary ease. All it took to cause panic selling was a mere *hint* of higher rates in Japan, and a *possible* suspension of further Fed easing. That's what made this particular plunge so ominous.

It should no longer come as any great surprise that even a slight backup in bond yields can force a horde of global speculators to run for the exits. But the scale of the recent speculative rampage was unprecedented. Leveraged speculation has evolved into a multinational industry, systematically seeking to exploit interest-rate differentials in virtually any markets, across virtually any currencies.

The problem, of course, is that this has proven to be destabilizing, not stabilizing, speculation. The same players increasingly place the same outsized bets, at the same time, based on the same economic assumptions. While these herd movements create paper profits for all in the short run, they inevitably increase risks in the long run.

This game can't last. As soaring volatility increases risk, yield differentials will have to widen to attract the hot money flows necessary to finance the deficits of the United States and the other debtor countries. To prevent this, the creditor central banks, particularly the BoJ, will be forced to step up their currency interventions almost without limit.

THE BULLS CHARGE ON

Remarkably, the sharp backup in bond yields has had only a fleeting impact on global equity markets. As soon as yields appeared to stabilize, the buying frenzy resumed. In the United States, the three conventional valuation measures have resumed their steady deterioration. The dividend yield on the S&P 500 has fallen to a record low 2.18%, and the price-earnings ratio is edging back towards 20. The market-to-book value ratio has hit another record high.

Undeterred by the slowdown in profit growth, money continues to pour into U.S. mutual funds. The onslaught in January and February – roughly \$50 billion – was more than double the year-earlier pace. But an even stronger bullish force has been the wave of stock buy backs and acquisitions. These have the twofold effect of reducing the supply of shares and increasing the cash holdings of investors.

We doubt this happy picture can last much longer. Despite continued massive inflows, the major U.S. indexes have lost considerable momentum, with the S&P 500 repeatedly failing to surpass its February 12 peak. The earnings outlook is deteriorating, although this trend has been somewhat masked by the tendency of Wall Street to judge profits against analysts' forecasts, which also are being ratcheted down.

The International Bond Plunge			
10-Year Bond Yields			
Country	High	Low	Basis Point Change
Canada	7.81% 3/15/96	6.92% 2/13/96	+88
France	6.77% 12/21/95	6.25% 1/22/96	+52
Germany	6.59% 3/11/96	5.78% 1/25/96	+81
Italy	11.23% 12/19/95	10.11% 1/96/96	+112
Japan	3.35% 2/27/96	2.80% 12/18/95	+55
Netherlands	6.58% 3/15/96	5.75% 1/18/96	+83
Spain	10.15% 3/18/96	9.28% 1/19/96	+87
Switzerland	4.52% 2/9/96	3.85% 1/18/96	+67
United Kingdom	8.19% 3/12/96	7.25% 1/18/96	+94
United States	6.45% 3/15/96	5.52% 1/18/96	+93

We can only speculate whether this marks a definitive top for the great bull market. Certainly, our expectation of continued economic sluggishness in the industrial countries argues against any near-term monetary shock.

But other dangers abound. The meltdown in the high-tech sector, where many leading stocks have declined 40% or 50% from their 1995 highs, is a clear warning of what could befall the overall market if the deterioration in profits exceeds even Wall Street's own falling expectations. Given our expectation of a U.S. recession, such a profits disappointment seems inevitable. The real question is whether the Fed will feel free to ease rates aggressively enough to offset any slump in earnings. But that question, like so many others regarding world financial markets, is best directed at monetary policy makers in Tokyo, not Washington.

CONCLUSIONS

Once again, massive dollar intervention by the Bank of Japan has saved the global bull market from utter ruin. In its desperate efforts to reflate the Japanese economy, the BoJ has become the lender of last resort to the U.S. Treasury – both directly, through its own dollar purchases, and indirectly, by dropping Japanese money rates to fantastically low levels, stimulating a tidal wave of leveraged yen-dollar speculation.

But the events of February and early March highlight the inherent instability of the credit pyramid the BoJ has constructed. They also suggest there is a finite limit on the willingness of global speculators to make such heavy, one-sided currency bets. Yet these hot money flows play an absolutely essential role in financing the chronic U.S. current account deficit and growing U.S. capital outflows.

In the end, we think the BoJ will have little choice but to expand its already massive dollar support operation. This should be reflected in still faster growth in the Fed's custodial holdings of Treasuries for foreign central banks. Indeed, the New York Fed's weekly report on those holdings now may be the single best barometer of the bond market's health.

In the short run, sluggish economic growth – if not outright recession – and subdued consumer and commodity price inflation should hold monetary policy in check. The prospect of easy money as far as the eye can see should continue to support financial markets. We wouldn't even rule out the possibility that stock and bond prices may set new highs, once the current excessive fears of faster growth dissipate.

But the longer-term picture is hardly benign. The steady tailing off of economic growth and investment in the industrial countries spells eventual trouble for today's absurdly overvalued stock markets. Future reports on corporate sales, productivity growth and profits are likely to make for grim reading. Sooner or later, these disappointments will outweigh the benefits of easy money and low interest rates.

We continue to advise our readers to focus on safety and liquidity, ideally by investing in the cash instruments and short-term bonds of the hard currency countries – Germany, Switzerland, Austria and the Netherlands.

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